

Michigan Law Review

Volume 88 | Issue 3

1989

Looking a Gift of Stock in the Mouth: Donative Transfers and Rule 10b-5

Carol J. Sulcoski
University of Michigan Law School

Follow this and additional works at: <https://repository.law.umich.edu/mlr>



Part of the [Securities Law Commons](#)

Recommended Citation

Carol J. Sulcoski, *Looking a Gift of Stock in the Mouth: Donative Transfers and Rule 10b-5*, 88 MICH. L. REV. 604 (1989).

Available at: <https://repository.law.umich.edu/mlr/vol88/iss3/5>

This Note is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

NOTE

Looking a Gift of Stock in the Mouth: Donative Transfers and Rule 10b-5

It may be more blessed to give than to receive. In today's litigious securities market, however, the donor of a gift of stock may not be "blessed," but may be a target of litigation instead. Consider the following example, in which an officer of a publicly held corporation owns a substantial number of shares in the corporation. This officer has access to nonpublic information about the future financial health of the corporation. Because this information indicates that the corporation will soon be in a precarious financial state, she can easily foresee that the value of the corporation's shares will drop when the information is made public. This officer knows she is prohibited by insider trading laws from selling her shares at their present, inflated value without disclosing the confidential information to which she is privy.¹ Yet she is unwilling to stand by and watch her shares devalue. Instead, she donates the shares to a charitable organization, taking a hefty tax deduction based on the current inflated value of the shares.² She then claims immunity from the insider trading prohibitions of the Securities Exchange Act of 1934,³ maintaining that the transaction

1. See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980) (discussing corporate insiders' duty to disclose material, nonpublic information). Section 10(b) of the Securities Exchange Act of 1934 prohibits the use of "any manipulative or deceptive device or contrivance" that contravenes SEC rules and regulations. 15 U.S.C. § 78j(b) (1988). Rule 10b-5, promulgated thereunder, prohibits three specific types of fraudulent or deceptive conduct "in connection with the purchase or sale of any security": (1) "any device, scheme, or artifice to defraud"; (2) "any untrue statement of a material fact" or omission of "a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading"; and (3) "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person . . ." 17 C.F.R. § 240.10b-5 (1988).

Section 10(b) and rule 10b-5 thus operate as "catch-all" antifraud provisions, reaching a wide range of fraudulent conduct that overlaps and extends beyond the ambit of more specific provisions. See *Chiarella*, 445 U.S. at 226; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202, 206 (1976) (quoting *Hearings Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (statement of attorney Thomas G. Corcoran), reprinted in 8 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at 115 (1934) ("The most relevant exposition of" § 10(b) in the legislative history describes it as "a catch-all clause to prevent manipulative devices.")).

2. See I.R.C. § 170(a)(1) (1982) (allowing deduction of the amount of a charitable donation from gross income). However, a taxpayer may not be entitled to a § 170 deduction if "the donor receives or expects to receive additional substantial benefits . . . [such] that a *quid pro quo* for the transfer exists . . ." *Ottawa Silica Co. v. United States*, 699 F.2d 1124, 1132 (Fed. Cir. 1983) (adopting U.S. Claims Court opinion); see also *United States v. American Bar Endowment*, 477 U.S. 105, 116-17 (1986). Thus, a § 170 income tax deduction may be lost where an individual obtains or expects a substantial benefit from a charitable donation. See *infra* section III.B.

3. 15 U.S.C. § 78j(b) (1988).

was a gift, not a sale,⁴ and thus outside the jurisdictional reach of the statute.

Alternatively, suppose that an individual agrees to donate shares of stock to an organization, based upon representations made by the organization's agent. After title to the shares is transferred, however, the donor discovers that the representations were false. The agent then defends against securities fraud claims⁵ by asserting that no purchase or sale of securities occurred and that the antifraud provisions of the 1934 Act are therefore inapplicable.

The above examples highlight an area of ambiguity in federal securities doctrine: although rule 10b-5, promulgated under section 10(b) of the 1934 Act, is an important vehicle for imposing liability for securities fraud,⁶ its contours are ill-defined.⁷ Broad statutory language and divergent judicial interpretations sometimes make it difficult to determine whether a transaction is a "purchase or sale" within the scope of the 1934 Act.

Section 10(b) and rule 10b-5 require that the allegedly fraudulent conduct take place "in connection with the purchase or sale of any security."⁸ To evade rule 10b-5 liability, then, one need only characterize the transaction in question as something other than a purchase or sale. Not surprisingly, litigants have advanced many creative arguments as to why an allegedly fraudulent transaction is or is not a "purchase" or "sale" for the purposes of rule 10b-5.⁹ The status of donative transfers, however, has never been directly addressed in the context of section 10(b) and rule 10b-5.¹⁰

4. See 15 U.S.C. § 78j(b) (1988) (§ 10(b)) (requiring that the alleged fraud take place "in connection with the purchase or sale of any security"); 17 C.F.R. § 240.10b-5 (1988) (rule 10b-5) (same).

5. Application of the federal securities laws may be desirable because they "can afford relief in situations where none would be available on applicable common-law principles" such as fraud. H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* 825 (1983).

6. See *supra* note 1.

7. See, e.g., *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) ("[W]e would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5."); Friedman, *The Concepts of Purchase and Sale under the Federal Securities Laws*, 14 N.Y. L.F. 608, 615 (1968) ("[F]ocusing on the [1934] Act as a whole, one will never be able to properly delimit the concepts of purchase and sale."):

8. 15 U.S.C. § 78j(b) (1988) (§ 10(b)); 17 C.F.R. § 240.10b-5 (1988) (rule 10b-5).

9. See, e.g., *Walling v. Beverly Enters.*, 476 F.2d 393 (9th Cir. 1973) (plaintiff claimed that defendant's entering into contract with "secret reservation" not to perform it constituted fraud under rule 10b-5); *Garner v. Pearson*, 374 F. Supp. 591, 598 (M.D. Fla. 1974) (fraudulent reduction of assets made depositors "forced sellers" of their securities because the securities had been reduced to mere claims in bank liquidation); *Keers & Co. v. American Steel & Pump Corp.*, 234 F. Supp. 201, 204 (S.D.N.Y. 1964) (rejecting claim of fraud when party intending to purchase shares died and executor refused to perform, noting "[s]urely [decedent] did not defraud plaintiffs by dying").

10. Courts have directly addressed the issue of donative transfers only in the context of § 16(b) of the 1934 Act, which is directed at short-swing insider trading. See *infra* Part II. The few rule 10b-5 cases that have touched on the issue of donative transfers have done so only

This Note explores whether a gift of stock can constitute a "sale" for the purposes of section 10(b) of the 1934 Act and rule 10b-5 promulgated thereunder. Part I reviews the relevant 1934 Act provisions, and concludes that although the statute's language and legislative history do not mention gifts of stock as such, they support the inclusion of gifts within the statute's scope. Part II examines a limited line of cases holding that a bona fide charitable gift is not a sale under section 16(b) of the 1934 Act.¹¹ This Part concludes that section 16(b) cases are not dispositive of the issue under section 10(b) and rule 10b-5 because section 16(b) serves different purposes and has a narrower scope than rule 10b-5. Part III discusses various transactions which courts have analyzed in light of the sale requirement to determine the distinguishing characteristics of a rule 10b-5 sale. This Part asserts that the hallmarks of a rule 10b-5 sale are a transfer of ownership or control of a security, an exchange of value or passing of consideration, and consistency with the remedial purposes of the 1934 Act. This Part also discusses the scienter requirement, which further limits the kinds of transactions subject to rule 10b-5.¹²

Part IV of this Note applies these elements of a rule 10b-5 sale to donative transfers. This Part concludes that in certain circumstances donative transfers of shares will manifest the three characteristics that define a rule 10b-5 sale — an ultimate transfer of ownership or control, some exchange of value or consideration, and consistency with the remedial purposes of the 1934 Act — and will also satisfy the scienter requirement. Finally, Part V evaluates the implications of this conclusion, demonstrating that the actual purchaser-seller requirement of *Blue Chip Stamps v. Manor Drug Stores*¹³ and other related policy considerations do not preclude a gift of stock from constituting a "sale" for rule 10b-5 purposes.

I. STATUTORY ANALYSIS OF SECTION 10(b) AND RULE 10b-5

The 1934 Act regulates the trading of securities and the structure

tangentially. See, e.g., *Rose v. Arkansas Valley Envtl. & Util. Auth.*, 562 F. Supp. 1180 (W.D. Mo. 1983) (holding that rule 10b-5 claim was not assignable through inheritance); *Kreindler v. Sambo's Restaurants, Inc.*, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,312, at 91,957, 91,960 n.2 (S.D.N.Y. Sept. 23, 1981) (refraining from addressing claims related to donative transfers because plaintiffs stipulated that they were not sales); *Center v. Hampton Affiliates, Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,487, at 93,814 (S.D.N.Y. June 28, 1978) (dismissing plaintiff's claim of fraud in connection with a gift for lack of specificity in pleadings). Compare *Brown, Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741, 764 n.83 (1985) ("Under the 1934 Act's definition, some gifts arguably are sales . . .") with L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 248 (1988) ("It would be hard to make a 'sale' out of a bona fide gift.").

11. 15 U.S.C. § 78p(b) (1988).

12. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976).

13. 421 U.S. 723 (1975).

of the federal securities market.¹⁴ As noted above, section 10(b), the statute's omnibus antifraud provision, prohibits the use of "any manipulative or deceptive device or contrivance," as defined by the rules and regulations of the Securities and Exchange Commission, "in connection with the purchase or sale of any security."¹⁵ Rule 10b-5, promulgated by the SEC under this rulemaking authority, prohibits three specific types of such fraudulent or deceptive conduct.¹⁶ This Part examines the statutory language and legislative background of section 10(b) and rule 10b-5, and concludes that both the language and the legislative history support the assertion that certain types of gifts should be considered "sales" for the purposes of rule 10b-5.

A. A Look at the Language

The logical starting point in determining the scope of a statute is, of course, the language of the statute itself.¹⁷ Although the language of the 1934 Act does not clearly demarcate the statute's scope, this language is broad enough to support the conclusion that some gifts of stock constitute rule 10b-5 sales.

The definitional section of the 1934 Act states that "[t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."¹⁸ As many courts have pointed out, this language is quite broad, and could plausibly be interpreted to include *any* transfer of a security, not merely a sale in the traditional sense.¹⁹ First, the verb "include" suggests that the drafters intended to embrace a wide variety of transactions within the term "sale."²⁰ In addition, many courts have emphasized the breadth of the phrase "or otherwise dispose of."²¹ If

14. See 15 U.S.C. § 78b (1988) ("[T]ransactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, . . . [and to] perfect the mechanisms of a national market system for securities . . .").

15. 15 U.S.C. § 78j(b) (1988).

16. 17 C.F.R. § 240.10b-5 (1988); see also *supra* note 1.

17. See, e.g., *Touche Ross & Co. v. Redington*, 442 U.S. 560, 568 (1979); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring); see also *Pinter v. Dahl*, 108 S. Ct. 2063, 2075 (1988).

18. 15 U.S.C. § 78c(a)(14) (1988).

19. See, e.g., *Alley v. Miramon*, 614 F.2d 1372, 1380 (5th Cir. 1980) ("Courts applying Section 10(b) and Rule 10b-5 have defined 'sale' broadly so as to extend the panoply of the 1934 Act to those who may not be sellers in the common law sense."); *Coffee v. Permian Corp.*, 434 F.2d 383, 385 (5th Cir. 1970) ("This broad language indicates a Congressional intent not to limit 'purchase' and 'sale' to traditional face-to-face commercial transactions.") (quoting *Fidelis Corp. v. Litton Indus.*, 293 F. Supp. 164, 170 (S.D.N.Y. 1968)).

20. *Vine v. Beneficial Fin. Co.*, 374 F.2d 627, 634 (2d Cir.) ("[T]he [use of the] verb 'include,' rather than the verb 'means,' emphasizes the breadth of this definition . . ."), *cert. denied*, 389 U.S. 970 (1967).

21. See, e.g., *Lincoln Natl. Bank v. Herber*, 604 F.2d 1038, 1040-41 (7th Cir. 1979); *Coffee*, 434 F.2d at 385; *Vine*, 374 F.2d at 634 ("the phrase[] . . . 'or otherwise dispose of' [is] hardly limiting"); *Bolger v. Laventhal, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 265-66 (S.D.N.Y. 1974); see also THE RANDOM HOUSE COLLEGE DICTIONARY 383 (rev. ed. 1988)

any manner of disposing of a security were to constitute a sale, as these courts have suggested, then every sort of fraudulent donative transfer which disposes of shares would be subject to 1934 Act regulation.

Not all courts, however, have embraced such a broad interpretation of the language. In *Sacks v. Reynolds*,²² for example, the District of Columbia Circuit rejected an expansive definition of sale, concluding that the "plain meaning" of the 1934 Act's language compelled a more restrictive definition. In *Sacks*, the court held that a transfer of stock between brokers, with the same customer retaining ownership, was not a transaction within the ambit of the 1934 Act.²³ The court reasoned that because ownership remained vested in the same individual, no sale or disposal of shares had occurred. The court suggested that a transaction must exhibit the "traditional elements of a sale" to fall within the ambit of rule 10b-5, but did not discuss exactly what those "traditional elements" are.²⁴

While the *Sacks* opinion's reliance on the "traditional elements" of a sale seems to preclude interpreting a gift as a rule 10b-5 sale, the District of Columbia Circuit's reasoning is unsatisfactory. The court offered no explanation as to what "traditional elements" of a sale place a transaction within rule 10b-5. Moreover, the *Sacks* court's "plain meaning" approach to the language of the 1934 Act provides little insight into the nature of a rule 10b-5 sale.²⁵ Because the relevant definitional provision of the 1934 Act includes two phrases with potentially conflicting connotations, a "plain meaning" interpretation changes with the statutory phrase one focuses upon. The phrase "or otherwise dispose of" is a catchall, which could be read so broadly as to encompass a very wide range of securities transactions. In contrast, the term "sale" implies a much narrower range of transactions. Thus, courts interpreting the same definitional provision have adopted widely divergent conceptions of the transactions which comprise a section 10(b) sale.²⁶

(definition of "dispose of" includes: "to deal with conclusively; settle" and "to get rid of; discard; give away.") (emphasis added).

22. 593 F.2d 1234 (D.C. Cir. 1978).

23. 593 F.2d at 1240.

24. 593 F.2d at 1240.

25. The court's dictionary definition of "dispose of" — "'to transfer into new hands or to the control of someone else (as by selling or bargaining away)'" — is ambiguous at best because a gift of shares, by transferring shares into the control of another, "disposes of" those shares as effectively as a sale. See 593 F.2d at 1240 n.13 (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 654 (1971)). A gift of shares obviously can transfer those shares into the control of someone else. To suggest that the quoted definition excludes transfers which are not traditionally sales is to treat the illustrative parenthetical ("as by selling or bargaining away") as exhaustive. 593 F.2d at 1240 n. 13 (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 654 (1971) (emphasis added); see also *infra* section IV.A; cf. THE RANDOM HOUSE COLLEGE DICTIONARY 383 (rev. ed. 1988) (quoted at note 21 *supra*).

26. Compare *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295 (5th Cir. 1978) (holding that a pledge of shares as collateral is not itself a § 10(b) sale) with *Mallis v.*

The language of the 1934 Act itself sheds little light on the breadth of the term "sale" for section 10(b) purposes. As the Supreme Court noted in *SEC v. National Securities, Inc.*,²⁷ the relevant definitional provision of the 1934 Act is "for the most part unhelpful."²⁸ Accordingly, this Note next looks beyond the bare language to its legislative history.²⁹

B. *The Intent of the 1934 Congress*

Despite the Supreme Court's emphasis on using the legislative history of a statute as a guide to the statute's interpretation,³⁰ legislative history is frequently nonexistent or unhelpful. This is certainly the case with section 10(b) of the 1934 Act and rule 10b-5.³¹ The legislative histories of the statute and the rule do not delineate the scope of the term "sale"; however, a careful examination of the legislative history shows that treating certain gifts as rule 10b-5 sales is consistent with the antifraud purposes of that rule.

As numerous courts and commentators have noted with chagrin, the legislative history surrounding section 10(b) is scant.³² Congressional concern surrounding the adoption of what is now section 10 of the 1934 Act centered on the advisability of prohibiting those fraudulent practices that were rampant at that time, such as short sales and

FDIC, 568 F.2d 824 (2d Cir. 1977) (acceptance of pledge as collateral for loan falls within rule 10b-5), *cert. dismissed*, 435 U.S. 381 (1978); compare also *International Controls Corp. v. Vesco*, 490 F.2d 1334 (2d Cir.) (consideration not required for rule 10b-5 sale), *cert. denied*, 417 U.S. 932 (1974) with *Lawrence v. SEC*, 398 F.2d 276 (1st Cir. 1968) (consideration essential to rule 10b-5 sale).

27. 393 U.S. 453 (1969).

28. 393 U.S. at 466.

29. Cf. Johnson & Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1916 n.213 (1989) ("[I]t is incorrect to conclude that, because meaning is ultimately arbitrary, 'anything goes' when one offers an interpretation of an old text. . . . The goal is to reconstruct the set of meanings — meanings of specific words as well as broader normative considerations — that informed the legislators' own use of language.").

30. See, e.g., *Cort v. Ash*, 422 U.S. 66, 78 (1975) (citing "legislative intent, explicit or implicit" and the "underlying purposes of the legislative scheme" as factors in determining whether a statute creates an implied right of action); see also *Santa Fe Indus. v. Green*, 430 U.S. 462, 473-74 & n.13 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976).

31. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). In *Blue Chip Stamps*, the Court noted the difficulty of divining legislative intent: "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. . . . [I]t would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5." 421 U.S. at 737.

32. See, e.g., *Hochfelder*, 425 U.S. at 201 (noting that the legislative history is "bereft of any explicit explanation of Congress' intent"); 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5, ¶ 5 (1981) ("It is . . . regrettable that the legislative and administrative history of Section 10(b) and the Rule are so sparse."); Thel, *The Original Conception of Section 10(b) of the Securities & Exchange Act*, 42 STAN. L. REV. (forthcoming 1990) (examining two competing conceptions of the 1934 Act in the absence of any clear legislative intent).

stop-loss orders.³³ The prevailing view in Congress was that some practices were being used solely "for the purpose of artificially raising or depressing security prices" and "serve[d] no legitimate function."³⁴ The drafters hoped to deter a wide range of fraudulent and needless transactions, and consequently described the potential conduct broadly.³⁵

The potential breadth of section 10(b) did not go unnoticed. One drafter, for example, summarized this provision as a single commandment, "Thou shalt not devise any other cunning devices," and noted, "I do not think there is any objection to that kind of a clause."³⁶ Similarly, a Senate committee report characterized the purpose of section 10(b) as "to prohibit or regulate the use of any other manipulative or deceptive practices which [the SEC] finds detrimental to the interests of the investor."³⁷ Congress created an omnibus antifraud provision to provide flexibility in enforcement, and deliberately eschewed delineating explicit limits for that section.³⁸

The background of rule 10b-5 is as cryptic as that of section 10(b). As one commentator has noted, "[t]he brief history [of rule 10b-5] consists of a short release, a paragraph in the SEC's 1942 annual report, and the subsequent recollections of an SEC staff attorney."³⁹ None of this background sheds any light on the jurisdictional scope of the rule, beyond the rule's intended use as an "additional protection to investors."⁴⁰

All we know for certain, then, is that the drafters of section 10(b) proposed to create a flexible antifraud provision to protect investors and the securities market from a variety of fraudulent devices. The

33. Short sales and stop-loss orders are examples of "practices . . . that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus.*, 430 U.S. at 476; see Sachs, *The Relevance of Tort Law Doctrine to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96, 118 (1985).

34. S. REP. NO. 792, 73d Cong., 2d Sess. 7 (1934), reprinted in 5 J. ELLENBERGER & E. MAHAR, *supra* note 1, at 7.

35. See *Hochfelder*, 425 U.S. at 203; 3A H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* ¶ 9.02 (1975); Thel, *supra* note 32 (arguing that the drafters intended § 10(b) to empower the SEC to regulate virtually any practice that might contribute to speculation in securities).

36. *Hearings Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (statement of attorney Thomas G. Corcoran), reprinted in 8 ELLENBERGER & MAHAR, *supra* note 1, at 115; see also Sachs, *supra* note 33, at 118 n.161.

37. S. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934), reprinted in 5 ELLENBERGER & MAHAR, *supra* note 1, at 18.

38. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (noting that the language of § 10(b) sheds little light on the intended "contours" of a private rule 10b-5 action); H. BLOOMENTHAL, *supra* note 35, at ¶ 9.02.

39. Sachs, *supra* note 33, at 120 (footnotes omitted). For a more detailed description, see *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (remarks of Milton Freeman) [hereinafter Freeman].

40. Sachs, *supra* note 33, at 120 n.179 (quoting SEC ANN. REP. 10 (1942)); see also Freeman, *supra* note 39, at 922-23.

SEC then promulgated rule 10b-5 as a means to achieve this end. Applying these provisions to gifts of stock that operate to defraud investors or attempt to evade federal regulations is fully consistent with these purposes. In this respect, the legislative histories of section 10(b) and rule 10b-5, meager as they are, support the assertion that at least some gifts of stock should be treated as sales for the purposes of section 10(b) and rule 10b-5. The following two Parts examine another important source of guidance: judicial interpretation of the term "sale" in the contexts of sections 16(b) and 10(b) of the 1934 Act.

II. THE SECTION 16(b) EXPERIENCE

Section 16(b) is a narrowly drawn provision of the 1934 Act that specifically prohibits short-swing insider trading.⁴¹ Section 16(b) creates a cause of action allowing the issuer of a stock (or a shareholder suing on the issuer's behalf) to recover short-swing profits obtained by a corporate insider who traded on material, nonpublic information.⁴² All courts that have addressed this issue have held that charitable gifts are not "sales" for the purposes of section 16(b).⁴³ At first glance, these decisions seem to suggest that a gift likewise would not qualify as a sale under section 10(b) and rule 10b-5. However, the section 16(b) cases are distinguishable based on the divergent scopes and purposes of the sections, and judicial admonitions to interpret different sections of the securities laws with regard to context. Thus, section 16(b) cases do not preclude certain donative transfers from falling within the reach of section 10(b) and rule 10b-5.

In *Shaw v. Dreyfus*, the Second Circuit found that a transaction in which a corporate director purchased stock and later gave it away as a gift was not within the purview of section 16(b) because the director did not personally profit from the transaction.⁴⁴ The court stated: "Certainly bona fide gifts, as these were conceded to be, are not within the accepted meaning of 'sales'; nor do they involve 'any contract to sell or otherwise dispose of' the property given."⁴⁵

41. 15 U.S.C. § 78p(b) (1988). Section 16(b) states, in pertinent part, that any profit realized by a corporate insider "from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of [the insider]" 15 U.S.C. § 78p(b) (1988). See *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 595 (1973) ("The statute requires the [statutorily defined] inside, short-swing trader to disgorge all profits realized on all 'purchases' and 'sales' within the specified time period, without proof of actual abuse of insider information, and without proof of intent to profit on the basis of such information.").

42. 15 U.S.C. § 78p(b) (1988); see *supra* note 41.

43. See *Portnoy v. Memorex Corp.*, 667 F.2d 1281 (9th Cir. 1982); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), cert. denied, 337 U.S. 907 (1949); *Lewis v. Adler*, 331 F. Supp. 1258 (S.D.N.Y. 1971); *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948).

44. *Shaw*, 172 F.2d at 142-43.

45. 172 F.2d at 142 (citing 15 U.S.C. § 78c(a)(14) (1988)).

A federal district court in New York had reached the same conclusion the previous year in *Truncale v. Blumberg*.⁴⁶ There, the court held that a gift of unexercised stock warrants to charitable agencies did not constitute a sale or purchase within the scope of section 16(b).⁴⁷ The *Truncale* court rejected arguments that the defendant, a corporate officer with nonpublic knowledge of a future merger, had donated stock options as a "tax dodge": "By no stretch of the imagination . . . can a gift to charity or indeed to anyone else when made in good faith and without pretense or subterfuge, be considered a sale or anything in the nature of a sale."⁴⁸

On the surface, the section 16(b) cases suggest that a gift of stock should also fall outside the reach of section 10(b) of the 1934 Act and rule 10b-5. Although the cases applied a different section of the 1934 Act, they did examine donative transfers within the general context of the 1934 Act, holding that such transfers do not constitute sales. A closer analysis, however, demonstrates that the section 16(b) line of cases is not dispositive of the status of a gift under section 10(b) and rule 10b-5.

Section 16(b) differs markedly from section 10(b) in both purpose and scope.⁴⁹ Section 16(b) is a narrow provision prohibiting a particular type of fraudulent activity, insider trading, when conducted under specific circumstances.⁵⁰ Section 16(b) has limited applicability, for it circumscribes the class of potential plaintiffs (only issuers or shareholders suing derivatively) and defendants (only a defined class of corporate insiders and ten percent shareholders), and allows recovery only of the short-swing profits obtained through insider trading within a six-month period.⁵¹ Accordingly, section 16(b) is not useful in the majority of fraud cases, nor even the majority of insider trading cases.

In contrast, courts have repeatedly termed section 10(b) and rule 10b-5 "catchall" antifraud provisions.⁵² They are flexibly applied to the gamut of fraudulent conduct, including but not limited to insider trading, misstatements in financial disclosure statements or prospectuses, and manipulative corporate conduct.⁵³ The only restrictions

46. 80 F. Supp. at 387.

47. 80 F. Supp. at 391.

48. 80 F. Supp. at 391. Similarly, in a recent Ninth Circuit case, a bank's good-faith donation to a charitable foundation was held to be a gift and thus outside the reach of § 16(b). *Portnoy v. Memorex Corp.*, 667 F.2d 1281, 1283 (9th Cir. 1982). The court did not explain its holding, relying on a flat assertion that the transaction was "a gift, not a sale." 667 F.2d at 1283.

49. Compare 15 U.S.C. § 78j(b) (1988) with 15 U.S.C. § 78p(b) (1988); see also H. HENN & J. ALEXANDER, *supra* note 5, at 650 n.19; L. SODERQUIST, *SECURITIES REGULATION: A PROBLEM APPROACH* 705 (1982); Brown, *supra* note 10, at 764 n.83.

50. H. HENN, *CORPORATIONS* 767 (1974).

51. See 15 U.S.C. § 78p(b) (1988).

52. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 226 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202, 206 (1976).

53. See *supra* note 1; see also, e.g., *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969) (applica-

placed upon the class of potential plaintiffs are that they be "actual purchasers or sellers"⁵⁴ of the security in question, and that they prove the defendant acted with scienter.⁵⁵ Moreover, the statutory language of section 16(b) requires the disgorgement of any *profit* obtained through insider trading,⁵⁶ whereas section 10(b) and rule 10b-5 reach more generally to any fraud in connection with a purchase or sale of securities. Thus, a transaction need not involve profit to fall within rule 10b-5, so long as some sort of fraud or deception was involved.⁵⁷ Furthermore, Congress intended section 10(b) to protect investors and the market from fraudulent devices of all kinds.⁵⁸ Given this broader scope, a different and broader interpretation of "sale" may be more appropriate for section 10(b) and rule 10b-5 actions than has been applied to section 16(b) actions.⁵⁹

Case law further supports the argument that "sale" be interpreted more broadly for section 10(b) than for section 16(b). The Supreme Court has indicated that, as a general canon of construction, the meaning of a particular statutory term cannot be divorced from its context.⁶⁰ The Court has specifically applied this method of interpretation to the federal securities laws: "The meaning of particular phrases must be determined in context [T]he same words may take on a different coloration in different sections of the securities laws; both the [Securities Act of 1933] and the 1934 Act[] preface their lists of general definitions with the phrase 'unless the context

tion to corporate reorganization); *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968) (application to misleading corporate press release), *cert. denied*, 394 U.S. 976 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) (application to insider trading case). *But see Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (holding that internal corporate mismanagement is not actionable under § 10(b)). For a general overview of the application of § 10(b), see H. HENN & J. ALEXANDER, *supra* note 5, at 825-31.

54. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749, 755 (1975). This actual purchaser-seller rule is discussed more fully in section V.A *infra*.

55. *Hochfelder*, 425 U.S. at 201; see A. JACOBS, *supra* note 32, at § 36. The scienter requirement is discussed fully in section IV.D *infra*.

56. 15 U.S.C. § 78p(b) (1988).

57. See Brown, *supra* note 10, at 764 n.83.

Other significant differences between § 16(b) and § 10(b) include: (1) section 16(b) is restricted to transactions involving equity securities, while § 10(b) applies to any security; (2) section 16(b) requires both a purchase and a sale within a six-month period, while § 10(b) requires either a purchase or a sale; and (3) the SEC has no enforcement authority under § 16(b); only private individuals can invoke its protection, unlike § 10(b), which is a primary tool for SEC enforcement of the 1934 Act. See *id.*

58. See *supra* note 35 and accompanying text.

59. See 15 U.S.C. § 78c (1988) (preface to definitional sections, stating "unless the context otherwise requires"); see also *SEC v. National Sec., Inc.*, 393 U.S. 453, 466-67 (1969) (noting that words take on different meanings in different provisions of securities laws) (citing *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 350-51 (1943)); *Herpich v. Wallace*, 430 F.2d 792, 806-07 (5th Cir. 1970); Brown, *supra* note 10, at 764 n.83.

60. *National Sec., Inc.*, 393 U.S. at 466.

otherwise requires.'"⁶¹ Thus, the Supreme Court has recognized that a statutory term such as "sale" may take on different shades of meaning with regard to section 10(b) and section 16(b).

Moreover, some courts and commentators have indicated that Congress specifically intended differing contextual interpretations of "sale" for sections 16(b) and 10(b).⁶² The Second Circuit has adopted this method of interpretation: "[W]e do not consider the interpretation of the terms 'purchase' and 'sale' as used in § 16(b) to be dispositive of their meaning in the context of § 10(b)."⁶³ The Second Circuit's reasoning further supports the assertion that gifts of stock could be considered sales for section 10(b) purposes, notwithstanding the line of cases finding bona fide charitable donations outside the scope of section 16(b).

In sum, the divergent scopes and purposes of sections 16(b) and 10(b), as well as judicial admonitions to interpret different sections of the securities laws with regard to context, demonstrate that section 16(b) cases are not dispositive of the status of gifts of shares under section 10(b). Thus, certain gifts could be included within the ambit of section 10(b) and rule 10b-5 without falling afoul of section 16(b) case law.

III. THE REACH OF SECTION 10(b)

No federal court has directly addressed the status of a gift of stock for the purposes of rule 10b-5, although a great deal of case law interprets the sale requirement in other contexts. Traditionally, courts have espoused an expansive definition of the term sale, holding that many diverse and nontraditional transactions constitute rule 10b-5 sales.⁶⁴ In recent years, the Supreme Court has cautioned against further expanding the scope of the 1934 Act, particularly in the context of section 10(b) and rule 10b-5.⁶⁵ The Court has not, however, aban-

61. 393 U.S. at 466 (quoting 15 U.S.C. § 77b (1988) (1933 Act) and 15 U.S.C. § 78c(a) (1988) (1934 Act)).

62. See *International Controls Corp. v. Vesco*, 490 F.2d 1334, 1343 n.8 (2d Cir.), cert. denied, 417 U.S. 932 (1974); *Blau v. Max Factor & Co.*, 342 F.2d 304, 307 (9th Cir.) (holding that a transaction is not a § 16(b) purchase if not conducive to the practices § 16(b) was specifically designed to prevent), cert. denied, 382 U.S. 892 (1965); see also *Brown*, *supra* note 10, at 764 n.83. Professor Friedman asserts: "Any proper search must locate separate limits on the concepts of purchase and sale for each of the disparate provisions of the Act, and even in some cases separate definitions for each rule under the same statutory section." Friedman, *supra* note 7, at 615-16.

63. *Vesco*, 490 F.2d at 1343 n.8.

64. The Supreme Court embraced an expansive approach to the term "sale" in early cases involving rule 10b-5. See, e.g., *SEC v. National Sec., Inc.*, 393 U.S. 453, 466-67 n.8 (1969) (noting that the relevant sections of the 1934 Act "indicate the breadth of the statutory terms ['sale' and 'purchase'] by using the definitional word 'include' and by including within the definitions contracts 'to buy, purchase, or otherwise acquire' and 'to sell or otherwise dispose of' securities.").

65. See, e.g., *SEC v. Sloan*, 436 U.S. 103, 116 (1978) (cryptically noting that the 1934 Act

doned the earlier caselaw: the variety of transactions still within the umbrella of rule 10b-5 demonstrates that a given transaction need not contain all of the elements of a common law sale to constitute a rule 10b-5 sale.⁶⁶

This Part analyzes the requirements of a rule 10b-5 sale by examining the types of transactions that courts have and have not termed rule 10b-5 "sales." This Part begins by describing three characteristics that mark a rule 10b-5 sale: (1) a transfer of ownership or control of the security; (2) some exchange of value; and (3) consistency with the remedial purposes of the 1934 Act.⁶⁷ This Part then discusses scienter, which has been an essential element of a rule 10b-5 action since the Supreme Court's decision in *Ernst & Ernst v. Hochfelder*.⁶⁸ This Part concludes that a transaction which exhibits these three transactional characteristics and which involves the requisite scienter is consistent with judicial and statutory conceptions of a rule 10b-5 sale; consequently, such a transaction should be actionable as a sale under rule 10b-5. This Part thus sets up the framework within which to analyze whether donative transfers are rule 10b-5 "sales."

cannot be read "more broadly than its language and statutory scheme reasonably permit"); see also *Chiarella v. United States*, 445 U.S. 222 (1980) (rejecting argument that duty to disclose arises from mere possession of material inside information); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (establishing scienter requirement for private claims under rule 10b-5); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (limiting rule 10b-5 standing to "actual purchasers and sellers" of securities).

66. For example, some courts have held that consideration or an exchange of value is not essential to a rule 10b-5 sale. See *infra* notes 93-95 and accompanying text. Similarly, courts have stated that a transaction need not be fully consummated to fall within rule 10b-5, as contracts to sell and purchase are explicitly included in the 1934 Act's definition. See, e.g., *Herpich v. Wallace*, 430 F.2d 792, 807-09 (5th Cir. 1970); 15 U.S.C. § 78c(a)(14) (1988) (defining "sale" to include contracts to sell securities). Courts have even deemed conditional and contingent contracts to be rule 10b-5 "sales." See *Yoder v. Orthomolecular Nutrition Inst.*, 751 F.2d 555, 559-61 (2d Cir. 1985); *International Controls Corp. v. Vesco*, 593 F.2d 166, 181 n.18 (2d Cir.), cert. denied, 442 U.S. 941 (1979) ("*Vesco II*"); *Mullen v. Sweetwater Dev. Corp.*, 619 F. Supp. 809, 814-16 (D. Colo. 1985).

67. Two other characteristics have been noted by many courts in determining that a given transaction is a rule 10b-5 sale: a change in the fundamental nature of the security or in the investment decision, and the effect of the transaction on the market as a whole. See, e.g., *Keys v. Wolfe*, 709 F.2d 413, 417 (5th Cir. 1983) (key question is "whether the transaction has wrought a fundamental change in the nature of the plaintiff's investment") (quoting *Rathborne v. Rathborne*, 683 F.2d 914, 920 (5th Cir. 1982)); *In re Penn Cent. Sec. Litig.*, 494 F.2d 528 (3d Cir. 1974) (court evaluated ultimate effect of merger on shareholders to determine if sale occurred); *Vine v. Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.) (adopting "forced seller" theory: because defendant's scheme irrevocably changed nature of plaintiff's investment by forcing conversion of shares into cash, sale had occurred despite lack of volitional act on plaintiff's part), cert. denied, 389 U.S. 970 (1967); *Umstead v. Durham Hosiery Mills, Inc.*, 578 F. Supp. 342, 346 (M.D.N.C. 1984) (merger effected change in nature of plaintiff's stock holdings sufficient to predicate rule 10b-5 standing). These characteristics, however, are not relevant to the status of a gift of shares under rule 10b-5.

68. 425 U.S. 185, 201 (1976).

A. *A Transfer in Ownership or Control*

A change in ownership or control of a security is probably the element most commonly cited by courts in determining whether a given transaction is a "sale." Emphasis on a transfer in ownership or control is an outgrowth of the definitional language of the 1934 Act, and is further supported by considerations of standing articulated by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*.⁶⁹

Section 3 of the 1934 Act provides definitions for many of the Act's key terms. Section 3(a)(14) defines "sale" simply by stating that "[t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."⁷⁰ This "or otherwise dispose of" language may explain why numerous courts regard a transfer of ownership or control of a security as one hallmark of a section 10(b) sale.⁷¹

The Second Circuit's decision in *International Controls Corp. v. Vesco* provides a good example of the importance of a transfer of ownership or control of shares.⁷² In *Vesco*, the plaintiff brought rule 10b-5 fraud claims based on a corporation's transfer of shares to its subsidiary.⁷³ The Second Circuit held that such a transfer did not constitute a sale under rule 10b-5, because ownership and control of the shares remained vested in essentially the same hands.⁷⁴ The court cited the "dispose of" language of section 3(a)(14), stating, "we cannot agree that by transferring its ownership of [the shares] to its wholly-owned subsidiary . . . [the corporation] in any sense 'disposed of' its . . . stock."⁷⁵

In evaluating whether a transfer of ownership or control, and thus

69. 421 U.S. 723 (1975); see *infra* notes 83-87 and accompanying text.

70. 15 U.S.C. § 78c(a)(14) (1988); see *supra* notes 18-28.

71. See, e.g., *Lincoln Natl. Bank v. Herber*, 604 F.2d 1038, 1040-41 (7th Cir. 1979) (emphasizing "or otherwise dispose of" language of 1934 Act in holding pledge of shares was not a rule 10b-5 sale); *International Controls Corp. v. Vesco*, 490 F.2d 1334, 1343 (2d Cir.) (finding no transfer of control and therefore no sale where corporation transferred shares to its own subsidiary), *cert. denied*, 417 U.S. 932 (1974); *McCloskey v. McCloskey*, 450 F. Supp. 991, 994-95 (E.D. Pa. 1978) (deposit of shares into voting trust not a sale where plaintiff's rights as to those shares remained essentially unchanged); see also *Blue Chip Stamps*, 421 U.S. at 750-51 n.13 (noting that the "otherwise dispose of" language indicated that the drafters had clearly anticipated some disposition of shares in imposing the sale requirement); 421 U.S. at 764 (Blackmun, J., dissenting) ("To my mind, the word 'sale' ordinarily and naturally may be understood to mean, not only a single, individualized act transferring property from one party to another, but also the generalized event of public disposal of property . . .").

72. 490 F.2d at 1334.

73. 490 F.2d at 1339.

74. 490 F.2d at 1343.

75. 490 F.2d at 1343. A Pennsylvania district court case is also instructive. In *McCloskey v. McCloskey*, 450 F. Supp. 991 (E.D. Pa. 1978), the court held that the plaintiff's deposit of shares into a voting trust did not constitute a rule 10b-5 sale. 450 F. Supp. at 995. The court emphasized that even after entering into the trust, the plaintiff retained all the rights of a shareholder except the right to vote. Because the plaintiff's interest in her shares was not "terminated or transformed in any real sense," and the plaintiff retained ultimate control over the shares, no rule 10b-5 sale had occurred. 450 F. Supp. at 995 (emphasis omitted).

a sale, has taken place, courts have focused on the ultimate effect of a transaction, rather than on a nominal change in title. For example, in *Vesco*, the Second Circuit analyzed the functional effect of the transaction in question.⁷⁶ Although title to the securities had changed (the shares being initially held in the parent corporation's name, then transferred to the subsidiary's name), the court was more concerned with the actual control of the shares, which had not changed fundamentally.⁷⁷

The transfer of ownership or control has even been dispositive when a transaction is conditional or contingent, such as when shares are pledged as collateral. Before the Supreme Court put this issue to rest in *Rubin v. United States*,⁷⁸ the various courts of appeals were split as to whether a pledge of shares is a rule 10b-5 sale.⁷⁹ Those circuits which held that a pledge of shares is a rule 10b-5 sale acknowledged that full title to the security does not pass with the pledge.⁸⁰ However, these courts found the potential for a change in ownership (should the pledgor default) sufficient to transform the transaction into a sale.⁸¹ Other circuits holding that a pledge of shares is not a rule 10b-5 sale emphasized the contingent nature of the transaction; these courts noted that a pledge of shares does not *always* involve an ultimate transfer of ownership, for if the pledgor does not default, no transfer occurs.⁸² Even though the circuits disagreed over the suffi-

76. The court examined the relationship between the two entities, concluding that "as long as [the plaintiff] retained sole ownership of [the subsidiary], it retained complete control over [the shares] and thus relinquished nothing in the exchange." 490 F.2d at 1343. Accordingly, such a "self-dealing" transaction resulted in no ultimate transfer of control, and was not a sale. 490 F.2d at 1343.

77. 490 F.2d at 1343.

78. 449 U.S. 424 (1981). In *Rubin*, the Supreme Court held that a pledge of shares was a sale of an interest in a security for the purposes of the 1933 Act. 449 U.S. at 429-31. Although the Supreme Court has not passed on this issue in terms of the 1934 Act, it has noted in dicta that a pledge of shares would constitute a sale for 1934 Act purposes. See *Marine Bank v. Weaver*, 455 U.S. 551, 554 n.2 (1982).

79. *Brown*, *supra* note 10, at 765 n.84; see, e.g., *Northland Capital Corp. v. Silver*, 735 F.2d 1421, 1430 n.15 (D.C. Cir. 1984) (describing circuit split); *Weaver v. Marine Bank*, 637 F.2d 157, 163-64 (3d Cir. 1980) (pledge is sale under 1934 Act), *revd. on other grounds*, 455 U.S. 551 (1982); *Lincoln Natl. Bank v. Herber*, 604 F.2d 1038, 1044 (7th Cir. 1979) (pledge is not sale under 1934 Act or Securities Act of 1933).

80. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1029 (6th Cir. 1979); *Mallis v. FDIC*, 568 F.2d 824, 829 (2d Cir. 1977), *cert. dismissed*, 435 U.S. 381 (1978); see also *Rubin*, 449 U.S. at 429 (holding a pledge of shares a sale under the 1933 Act because a pledge vests in the pledgee "a power that could, at the option of the pledgee . . . in the event of a default, vest absolute title and ownership.").

81. See, e.g., *Herber*, 604 F.2d at 1044 ("It is possible that a sale may occur at a later point if the pledgee in fact forecloses on the stock after default on the loan, for then title actually passes and the pledgee becomes an unwilling purchaser of the stock.").

82. See, e.g., *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1299-1300 (5th Cir. 1978) (holding that a mere pledge is not a sale since "[t]he rights and privileges of the parties are not affected by a pledge in the same manner as by a 'sale' or 'purchase'"; foreclosure would, however, bring the pledge within the scope of the 1934 Act since foreclosure would

ciency of a contingent transfer of ownership, all focused on the potential transfer of ownership as the dispositive factor.

This emphasis on a change in ownership or control is also supported by considerations of standing — particularly a reluctance to grant rule 10b-5 standing to plaintiffs who have not actually purchased or sold shares. The Supreme Court addressed this concern in *Blue Chip Stamps v. Manor Drug Stores*.⁸³ In that case, the Court held that a plaintiff lacked standing to sue under the 1934 Act where the defendant's alleged misrepresentations caused the plaintiff to forego purchasing stock.⁸⁴ The Court held that only actual purchasers or sellers of securities may bring suit under rule 10b-5.⁸⁵ Although the Supreme Court justified its holding by citing the dangers of strike suits and problems of proof, it also expressed concern that no actual transfer of ownership had taken place.⁸⁶ Without any transfer of securities from plaintiff to defendant (or vice versa), there was no transaction upon which to predicate standing.⁸⁷

Thus, the first characteristic of a rule 10b-5 sale is the transfer of ownership or control, *i.e.*, a disposition, of a security. The requirement that some disposition of a security take place is supported by the language of the 1934 Act, as well as judicial interpretations of that language, and is also supported by the practical considerations involved in notions of standing.

B. *Exchange of Value or Consideration*

In addition to a transfer of ownership or control, courts have held that a rule 10b-5 sale must involve an exchange of value.⁸⁸ A *quid pro quo* requirement is emphasized in the case law, finding support in both the statutory language and traditional common law notions of sale. This section asserts that an exchange of value is necessary for a transaction to constitute a rule 10b-5 sale; moreover, this section suggests

result in the actual transfer of title); *McClure v. First Natl. Bank*, 497 F.2d 490, 495-96 (5th Cir. 1974) (same), *cert. denied*, 420 U.S. 930 (1975).

83. 421 U.S. 723 (1975). For a more detailed discussion of *Blue Chip Stamps*, see *infra* section V.A.

84. The plaintiff in *Blue Chip Stamps* claimed that the defendant deliberately portrayed its stock as a risky investment in order to prevent the plaintiff from exercising a court-ordered option to buy. The defendant then sold the shares to the public at a price that was much higher than the court-ordered price. 421 U.S. at 726-27.

85. 421 U.S. at 731.

86. 421 U.S. at 741-43, 746, 751, 754. The Court noted that the "or otherwise dispose of" language of § 3 indicated that the drafters clearly had anticipated some disposition of shares in imposing the sale requirement. 421 U.S. at 750-51 & n.13.

87. See 421 U.S. at 750-51 & n.13.

88. See, e.g., *Gurvitz v. Bregman & Co.*, 379 F. Supp. 1283 (S.D.N.Y. 1974) (stock split is not a sale); *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154 (S.D.N.Y. 1974) (exchange of maintenance contracts coupled with additional merchandise without charge was a sale because merchandise involved additional maintenance obligations); *Collins v. Rukin*, 342 F. Supp. 1282 (D. Mass. 1972) (stock option contract is a sale where part of employment contract).

that this "for value" requirement be construed to mean some direct and tangible form of pecuniary benefit.

Section 3(a)(14), the 1934 Act provision defining the term "sale," states merely that the term "sale" encompasses "any contract to sell or otherwise dispose of" a security.⁸⁹ Courts which have imposed a value requirement acknowledge that no explicit value requirement was included within this definition, and point instead to the definitional language of the 1933 Act for guidance. The 1933 Act defines "sale" to "include every contract of sale or disposition of a security or interest in a security, *for value*."⁹⁰ The lack of a similar "for value" provision in the 1934 Act was merely a congressional oversight, these courts claim, and Congress intended the term "sale" to have the same meaning in both statutes.⁹¹ Accordingly, these courts have found an exchange of value to be an essential ingredient of a 1934 Act sale.⁹²

Not all courts, however, have accepted the assertion that an exchange of value was an unintentional omission or implicit assumption with regard to the 1934 Act. In fact, some courts have concluded that Congress intentionally omitted an explicit value requirement, and that, therefore, no exchange of value need occur for a 1934 Act sale to take place.⁹³ For example, in *International Controls Corp. v. Vesco*, the Second Circuit held that a stock dividend given by a corporation

89. 15 U.S.C. § 78c(a)(14) (1988).

90. 15 U.S.C. § 77b(3) (1988) (emphasis added); see also *Pinter v. Dahl*, 108 S. Ct. 2063, 2076-77 (1988).

91. Some courts have held that there is no functional difference between the definitional provisions of the 1933 Act and the 1934 Act. For example, the Seventh Circuit has stated that there is "no reason not to interpret the definitions of the two acts in the same fashion." *Lincoln Natl. Bank v. Herber*, 604 F.2d 1038, 1041 (7th Cir. 1979); see also *Lawrence v. SEC*, 398 F.2d 276, 280 (1st Cir. 1968) ("We have no reason to believe that Congress intended, one year after the passage of the [1933] Act, to dilute the concept of 'sale' in the [1934] Act."). These courts have emphasized that the federal securities laws were meant to be a consistent and coherent whole; interpreting the same term in different ways would seem contrary to a unified scheme of federal securities regulation. See *Tcherepnin v. Knight*, 389 U.S. 332, 335-37 (1967) (determining the proper definition of the term "security"); *Brown*, *supra* note 10, at 765 & n.86.

92. See, e.g., *Herber*, 604 F.2d at 1041; *National Bank of Commerce v. All Am. Assurance Co.*, 583 F.2d 1295, 1298 (5th Cir. 1978); *Lawrence*, 398 F.2d at 280; *Gurvitz*, 379 F. Supp. at 1286; *Collins*, 342 F. Supp. at 1290.

93. See, e.g., *Rathborne v. Rathborne*, 683 F.2d 914, 920 (5th Cir. 1982); *International Controls Corp. v. Vesco*, 490 F.2d 1334 (2d Cir.), *cert. denied*, 417 U.S. 932 (1974). In addition, the legislative history of the 1934 Act supports this view, suggesting that Congress intended to narrow the general scope of the 1934 Act in comparison to the 1933 Act. See *Brown*, *supra* note 10, at 766 n.86. Compare S. 2693, 73d Cong., 2d Sess. § 3.12 (1934), *reprinted in* 11 J. ELLENBERGER & E. MAHAR, *supra* note 1, § 3.12 (in the original draft of the 1934 Act, the definition of "sale" resembled the broader 1933 Act definition) with 15 U.S.C. § 78c(a)(14) (1988) (the more narrow definition of "sale" in the current statute). At least one commentator concludes that Congress "intentionally differentiated between the definitions in the 1933 and 1934 Acts." *Brown*, *supra* note 10, at 766 n.86. If Congress did intend to differentiate between the statutes even in limited ways, then the assumption that the scope of the 1934 Act necessarily mirrors the scope of the 1933 Act is questionable. If, on the other hand, Congress differentiated between the two acts by narrowing the scope of the 1934 Act, then imposing a value requirement upon the 1934 Act is consistent with such differentiation.

to its shareholders was a 1934 Act sale, despite the fact that the shareholders did not proffer anything of value in exchange.⁹⁴ The court explained:

Nor do we believe, as our dissenting brother suggests, that because [appellant's] shareholders were not required to part with consideration in return for the dividend of . . . stock, the transaction was beyond the purview of § 10(b). By thus focusing on the absence of harm to the recipient shareholders, the dissent simply ignores the fact that the statute was intended to safeguard not only the shareholders of a defrauded corporation, but its creditors as well. . . .

We therefore reject our dissenting brother's paean to literalness in construing the term "sale" to require the passage of consideration in order to inject the requisite significance into the disposition of securities.⁹⁵

If this interpretation is correct, and the 1934 Act contains no value requirement, then it becomes easier to characterize gifts as rule 10b-5 sales. It seems unlikely, however, that Congress would so drastically alter the accepted meaning of "sale" in the 1934 Act without any indication in the statute or legislative history. As the First Circuit explained in holding that a written agreement to deliver shares was a 1934 Act sale:

We are unable to detect any significant difference so far as the transaction in this case is concerned between the two relevant statutes. Both cover contracts for the sale or other disposition of a security. . . .

We have no reason to believe that Congress intended, one year after the passage of the [1933] Act, to dilute the concept of "sale" in the [1934] Act.⁹⁶

Absent more definitive evidence suggesting such a dilution, it seems reasonable to assume that Congress implicitly incorporated a value requirement into the concept of sale for the purposes of the 1934 Act, as well as the 1933 Act.

Imposition of a value requirement finds further support in traditional common law notions of sale. Black's Law Dictionary, for example, defines "sale" as the "[t]ransfer of property *for consideration* either in money or its equivalent"; it further states that a sale differs from a gift "in that the latter transaction involves no return or recompense for the thing transferred."⁹⁷ Similarly, common law contract principles require some passing of consideration, or promise of consideration, to create an enforceable contract to sell.⁹⁸ The Uniform Commercial Code has also integrated the concept of consideration in its definition of "sale": section 2-106(1) of the UCC defines sale as "the

94. 490 F.2d at 1345.

95. 490 F.2d at 1346.

96. *Lawrence v. SEC*, 398 F.2d 276, 280 (1st Cir. 1968).

97. BLACK'S LAW DICTIONARY 1200 (5th ed. 1979) (emphasis added).

98. See, e.g., J. CALAMARI & J. PERILLO, *CONTRACTS* 185-86 (3d ed. 1987); O.W. HOLMES, *THE COMMON LAW* 253 (1881).

passing of title from the seller to the buyer for a price.”⁹⁹ Explanations proffered for this requirement of consideration are myriad,¹⁰⁰ whatever the origin, however, the concept of consideration as a required element of a sale is deeply rooted in the common law.

Although many judicial interpretations of rule 10b-5 sales have required some *quid pro quo* or exchange of value, that requirement need not be interpreted rigidly. Many courts that have required an exchange of value have defined “value” broadly. For example, in *Ingenito v. Bermec Corp.*,¹⁰¹ a United States district court in New York, examining a series of transactions involving the sale of cattle and maintenance contracts, stated that “consideration sufficient to find a disposition of a security for value is not limited to money or property.”¹⁰² The *Ingenito* court found that the obligations which arose from an exchange of maintenance contracts and the accompanying gift of cattle constituted a sale of securities.¹⁰³ The court reasoned that additional cattle created increased maintenance charges and thus required continuous participation in the defendant’s maintenance program; accordingly, accepting the gift of cattle necessarily imposed an obligation to pay future maintenance charges.¹⁰⁴ This loosely structured *quid pro quo* — cattle given with the expectation of receiving future maintenance contracts — involved an exchange of value sufficient to trigger the protection of the 1934 Act.¹⁰⁵

Other courts have been equally flexible in finding some sort of exchange of value in a transaction. For example, the Fifth Circuit has deemed an agreement to forbear legal action in exchange for securities a rule 10b-5 sale, because the potential plaintiff’s surrendering of a legal interest provides the “value” in exchange for the securities.¹⁰⁶ Even consideration deemed inadequate has been held sufficient to fulfill a value requirement. For instance, in *Rekant v. Desser*,¹⁰⁷ the Fifth Circuit held that a sale had occurred when a corporation issued securities in exchange for grossly inadequate consideration. The court found the inadequacy of the exchange irrelevant in determining whether value had been exchanged and a sale had occurred.¹⁰⁸ At least one court has even found a value requirement fulfilled when the intended

99. U.C.C. § 2-106 (1987).

100. See, e.g., J. CALAMARI & J. PERILLO, *supra* note 98, at 185-87.

101. 376 F. Supp. 1154 (S.D.N.Y. 1974).

102. 376 F. Supp. at 1182.

103. 376 F. Supp. at 1180-82.

104. 376 F. Supp. at 1181-82.

105. 376 F. Supp. at 1182.

106. See *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 528 (5th Cir. 1974).

107. 425 F.2d 872 (5th Cir. 1970).

108. 425 F.2d at 882; see also *Bolger v. Laventhal, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 266 (S.D.N.Y. 1974) (where limited partners surrendered securities in dissolution intending to receive cash, surrendering was sale despite no eventual recovery of cash).

consideration is later found to be spurious.¹⁰⁹ The case law suggests, then, that a value requirement need not be defined by rigid notions of what constitutes a sufficient *quid pro quo*.

In sum, the concept of an exchange of value as an essential element of a rule 10b-5 sale is supported by judicial interpretations of that rule, and is consistent with both statutory and common law notions of the term "sale." A "for value" requirement is thus the second element necessary for a transaction to constitute a rule 10b-5 sale.

C. *Original Purposes of the 1934 Act*

Courts have frequently examined the substance of a transaction in light of the perceived purposes of the 1934 Act to determine if that transaction constitutes a rule 10b-5 sale.¹¹⁰ Section 10(b) and rule 10b-5 were adopted as broad antifraud measures to protect both the individual investor and the overall integrity of the securities market.¹¹¹ Accordingly, courts often require that a given transaction involve the type of fraudulent conduct Congress intended to prohibit by passing the 1934 Act as a prerequisite to finding rule 10b-5 liability.¹¹²

The Supreme Court articulated this approach in *SEC v. National Securities, Inc.*¹¹³ *National Securities* involved alleged misrepresentations made during the course of a merger. The misrepresentations deceived plaintiffs into voting for the merger, requiring plaintiffs to exchange their shares in the original company for shares in the defendant's company. In determining whether this exchange of shares was actionable under rule 10b-5, the Court acknowledged that the definitional sections of the 1934 Act, the usual starting point for analysis, were unhelpful.¹¹⁴ Consequently, the Court described the focus of its inquiry as "whether respondents' alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule."¹¹⁵

109. See, e.g., *Frigitemp Corp. v. Financial Dynamics Fund*, 524 F.2d 275, 281 (2d Cir. 1975) (contribution of shares with no direct consideration a sale under rule 10b-5); *Aronstam v. Tenney Corp.*, [1968 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,237 (S.D.N.Y. July 24, 1968) (denying defendant's motion for summary judgment where securities were issued in exchange for worthless properties).

110. See, e.g., *SEC v. National Sec., Inc.*, 393 U.S. 453, 467 (1969) (describing inquiry as whether "broad antifraud purposes of the statute and the rule would clearly be furthered by their application to this type of situation"); *Lincoln Natl. Bank v. Herber*, 604 F.2d 1038, 1041 (7th Cir. 1979) (advocating an analysis which evaluates the transaction's "consistency with the purposes for which the legislation was enacted"); *Continental Commodities Corp.*, 497 F.2d at 527-28 ("Amenability of particular securities to [the purchase-sale requirement] is determined by whether the transactions in which the securities are issued are subject to the abuses sought to be eliminated by the individual Acts.").

111. See *supra* section I.B.

112. See *supra* note 110.

113. 393 U.S. at 467.

114. 393 U.S. at 466; see *supra* section I.A.

115. 393 U.S. at 467.

The Court concluded that the "broad antifraud purposes of the statute and the rule" would be furthered by applying section 10(b) and rule 10b-5, since the alleged fraud had induced individual investors to exchange their shares in much the same way as a typical cash sale.¹¹⁶ Justice Marshall's opinion, however, shed no further light on the nature or scope of those "broad antifraud purposes."

Two years later, the Court elaborated on the perceived purposes of the 1934 Act in *Superintendent of Insurance v. Bankers Life & Casualty Co.*¹¹⁷ Although the Court noted that section 10(b) was intended to preserve the overall integrity of the securities market, the Court cautioned that this was not the only purpose of the 1934 Act — protecting individual shareholders from fraudulent schemes was an equally important goal.¹¹⁸ In a footnote, the majority reiterated the breadth of these purposes: all types of fraudulent schemes were within the intended reach of the 1934 Act, both the "'garden variety' type of fraud" and the "'unique form of deception.'"¹¹⁹

The view of the 1934 Act's purposes adopted by the *Bankers Life* Court is flexible and broad. While more recent Supreme Court decisions have tended to cut back on the scope of rule 10b-5,¹²⁰ the legislative purposes approach still gives courts virtually unbridled discretion in deciding which fraudulent transactions will predicate liability under the 1934 Act.¹²¹ Because this approach gives little definitive guidance to courts or litigants in a particular case, it should not be the sole criterion for evaluating whether a transaction is a sale under rule 10b-5. However, consistency with the remedial purposes of the 1934 Act remains an important element in evaluating rule 10b-5 sales.

D. The Scierter Requirement

In addition to the structural elements of a rule 10b-5 sale, a transaction must reflect the requisite mental state to fall within the scope of the 1934 Act. This section, therefore, will briefly discuss rule 10b-5's scierter requirement.

As part of its more conservative interpretation of securities statutes,¹²² the Supreme Court has established a scierter requirement for rule 10b-5 actions. In *Ernst & Ernst v. Hochfelder*, the Court held that

116. 393 U.S. at 467.

117. 404 U.S. 6 (1971).

118. 404 U.S. at 10. Consequently, it became irrelevant whether a transaction occurred on an organized securities exchange or through a face-to-face transaction. 404 U.S. at 10.

119. 404 U.S. at 11 n.7 ("[We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' . . . Novel or atypical methods should not provide immunity from the securities laws.") (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)).

120. See *supra* note 65 and accompanying text.

121. See generally *supra* Part I and *infra* section IV.C.

122. See *supra* note 65 and accompanying text.

a section 10(b) plaintiff must show that the defendant acted with the requisite intent to defraud.¹²³

In *Hochfelder*, the plaintiff brought several 1934 Act claims against an accounting firm. The accounting firm had audited the records of a brokerage house; during this time, the president of the brokerage house induced the plaintiff to invest in a scheme that was later found to be fraudulent.¹²⁴ The plaintiff alleged that the accounting firm was negligent during its periodic audits in failing to discover the brokerage house fraud.¹²⁵

The Supreme Court reversed the lower court's judgment against the accounting firm, concluding that a showing of scienter was essential to a rule 10b-5 claim.¹²⁶ The Court interpreted the language of section 10(b) and rule 10b-5, particularly the terms "manipulative or deceptive" and "device and contrivance," as "strongly suggest[ing]" a requirement of "knowing or intentional misconduct."¹²⁷ Thus, establishment of the requisite mental state became an essential element of any rule 10b-5 action.¹²⁸

In sum, this Part has described three characteristics of a rule 10b-5 sale. Those characteristics are (1) a transfer of ownership or control of a security; (2) some exchange of value; and (3) consistency with the remedial purposes of the 1934 Act. In addition, this Part has discussed the Supreme Court's establishment of a scienter requirement in rule 10b-5 actions. Thus, a framework exists within which courts can evaluate a given transaction to determine whether that transaction falls within the range of conduct prohibited by rule 10b-5. The remainder of this Note uses this framework to evaluate donative transactions under rule 10b-5 of the 1934 Act.

IV. EVALUATING A GIFT OF STOCK AS A RULE 10b-5 SALE

As previously discussed,¹²⁹ the definitional provisions of section 10(b) and rule 10b-5 fail to delineate in more than a cursory way the kinds of transactions included within their scope. Moreover, the history of section 10(b) and rule 10b-5 sheds little light on the status of a gift of shares.¹³⁰ Similarly, judicial review of donative transfers under the 1934 Act has been limited to interpretation of section 16(b).¹³¹ No

123. 425 U.S. 185, 201 (1976).

124. 425 U.S. at 188-90.

125. 425 U.S. at 190.

126. 425 U.S. at 212-15.

127. 425 U.S. at 197.

128. 425 U.S. at 212. The Court defined "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. at 194 n.12.

129. See *supra* section I.A.

130. See *supra* section I.B.

131. See *supra* Part II.

court has yet passed on the status of a gift of shares within the context of section 10(b) and rule 10b-5.¹³²

The previous Part described a four-part framework within which courts evaluate the substance of a transaction to determine if that transaction is a sale subject to the strictures of rule 10b-5. Analysis of gifts of securities in light of this framework demonstrates that donative transfers should be deemed rule 10b-5 sales in some circumstances.

A. *The Transfer of Ownership Requirement*

The first element of a rule 10b-5 sale requires that the transaction result in a transfer of ownership or control of the security.¹³³ There can be little doubt that a gift of stock transfers ownership or control of a security, thus satisfying this first requirement. A gift of shares necessarily involves a divestment of ownership and control.¹³⁴ In this respect, a genuine gift is similar to traditional notions of sale, as there is a disposition of title and control. A gift of stock results in the same permanent transfer of ownership and control that courts have emphasized in the context of rule 10b-5 sales; to this extent, then, treating a gift of stock as a rule 10b-5 "sale" is fully consistent with existing judicial emphasis on a transfer of ownership or control.

B. *The Exchange of Value Requirement*

The second element of the suggested framework requires some exchange of value or consideration as part of the transaction.¹³⁵ This requirement is suggested by the statutory language of the 1933 Act, and is consistent with traditional notions of the term "sale." At first glance, there seems a clear intuitive distinction between a gift and a sale: in a sale, some consideration or thing of value is exchanged for another, while a gift presumably involves the disposition of something of value without recompense.¹³⁶ Thus, the value requirement will place many gifts outside the scope of rule 10b-5.

Requiring an exchange of value as an element of a rule 10b-5 sale, however, need not place *all* donative transfers outside the reach of the

132. See *supra* note 10 and accompanying text.

133. See *supra* section IV.A.

134. See Colliton, *The Meaning of "Contribution or Gift" for Charitable Contribution Deduction Purposes*, 41 OHIO ST. L.J. 973, 975 (1980) (discussing gifts in context of federal income tax regulation).

135. See *supra* section III.B. Some courts have argued that no value requirement attaches to the 1934 Act. See *supra* notes 93-95 and accompanying text. While this Note concludes that the imposition of a value requirement is the better view, if the 1934 Act does not contain a value requirement, then it becomes much easier to argue that donative transfers fall within the scope of rule 10b-5.

136. See, e.g., *United States v. American Bar Endowment*, 477 U.S. 105 (1986); *Commissioner v. Duberstein*, 363 U.S. 278 (1960); see also *BALLENTINE'S LAW DICTIONARY* 1133 (3d ed. 1969) (defining "sale" to include consideration); *BLACK'S LAW DICTIONARY* 1200 (5th ed. 1979) (same).

1934 Act. First, certain kinds of donative transfers do provide something of value to the donor. An obvious example is that of the gift which results in financial benefit to the donor through the workings of the federal income tax code. Consider the hypothetical described earlier, involving a corporate insider with nonpublic information about the declining value of her shares. If this insider gives away those shares, she may be entitled to take a tax deduction based on the current market value of those shares.¹³⁷ That deduction may be quite sizable, especially in relation to the future market value of the shares. In such a case, tax benefits would provide tangible economic "value" to satisfy the exchange of value requirement.¹³⁸ Thus, rule 10b-5 liability could attach to this type of donative transfer which has all the earmarks of insider trading, but masquerades as a charitable gift.

Second, if a broader notion of value is used, as discussed above, donative transfers that provide the giver with other kinds of benefits or values could be included within the scope of rule 10b-5. As one commentator has noted in the context of gifts made to charitable organizations:

[A] great variety of benefits, tangible and intangible, direct and indirect . . . may accrue to transferors as a result of what they claim to be charitable contributions. At one end of the benefits spectrum is the personal satisfaction that a donor receives from a generous act of philanthropy. At the other end is the direct and tangible economic benefit that a transferor receives when selling property to a charitable organization at a price below its fair market value. Within these two extremes are benefits such as those realized by the transferor as an individual member of the general public which . . . derives benefits from the transferee's charitable activities, the good will that a business may derive from its name being identified with the charitable organization or property owned by it, the increased value of privately-owned property occasioned by its proximity to a public park, roadway or school, and the direct benefit that may be derived from services performed for the transferor by the charitable organization.¹³⁹

The concept of value in the gift-giving context is admittedly a slippery one. If this part of the suggested analysis is to be workable in any practical sense, some guidelines as to what constitutes sufficient value are needed.

The Seventh Circuit suggested a workable definition of value in

137. I.R.C. § 170 (1982); see also M. ROSE & J. CHOMMIE, *FEDERAL INCOME TAXATION* 664-79 (3d ed. 1988); *supra* note 2.

138. See *SEC v. International Mining Exch., Inc.*, 515 F. Supp. 1062, 1069 (D. Colo. 1981) (holding that tax benefits may be profit for purposes of federal securities laws); *Stowell v. Ted S. Finkel Inv. Servs.*, 489 F. Supp. 1209, 1221 (S.D. Fla. 1980) (same), *aff'd.*, 641 F.2d 323 (5th Cir. 1981); Brown, *supra* note 10, at 764 n.83.

139. Hobbet, *Charitable Contributions — How Charitable Must They Be?*, 11 SETON HALL L. REV. 1, 2 (1970).

CBI Industries v. Horton.¹⁴⁰ In *Horton*, a corporate insider used non-public information to target lucrative purchases of securities, then deposited the profits in a trust fund for his sons.¹⁴¹ The Seventh Circuit held that the defendant did not *personally* profit from the short-swing sales of the shares, and thus did not violate section 16(b) of the 1934 Act.¹⁴² The court held that a corporate insider must gain some "direct pecuniary benefit" in order to be liable for the profits from such an insider purchase.¹⁴³

The Seventh Circuit's articulation of a "direct pecuniary benefit" standard defines the requirement of an exchange of value. The "direct pecuniary benefit" standard strikes the appropriate balance between a need for flexibility in evaluating transactions and the need for coherent line-drawing. It is sufficiently flexible to encompass within rule 10b-5 more ingenious methods of direct benefit, such as substantial income tax deductions, yet would exclude from the reach of rule 10b-5 intangible benefits, such as a donor's emotional gratification, and indirect benefits, such as the benefits accruing to a relative.

Using the *Horton* court's "direct pecuniary benefit" standard, then, a reviewing court should examine the donative transfer in question to see if such a benefit flows from the transaction.¹⁴⁴ This sort of tangible benefit would fulfill the value requirement of the suggested framework. If no direct pecuniary benefit accrues to the donor as part of the transaction, then no value was exchanged, and consequently, the transaction falls outside of section 10(b)'s scope.

C. Consistency with the Remedial Purposes of the 1934 Act

As discussed previously, courts have often examined the substance of a transaction with regard to the underlying purposes of the 1934 Act to determine if that transaction should be termed a rule 10b-5 sale.¹⁴⁵ Because certain types of donative transfers can defraud investors or interfere with the integrity of the securities market as much as any transaction traditionally deemed a sale, their inclusion within the

140. 682 F.2d 643 (7th Cir. 1982).

141. 682 F.2d at 644.

142. 682 F.2d at 646.

143. 682 F.2d at 646. The court rejected a broader notion of "benefit" in which "ties of affinity or consanguinity" or "an enhanced sense of well-being" would provide sufficient personal gain to trigger § 16(b) liability. 682 F.2d at 646.

144. *Cf. Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, the Supreme Court held that the SEC must show that a defendant personally benefited from disclosing inside information ("tipping") in a rule 10b-5 prosecution for insider trading. In discussing what kind of personal gain triggered a duty to disclose, the Court sketched a loose notion of "benefit," speaking of "a direct or indirect personal benefit . . . such as a pecuniary gain or a reputational benefit that will translate into future earnings." 463 U.S. at 663. The Court elaborated: "For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient." 463 U.S. at 664.

145. See *supra* section III.C.

scope of rule 10b-5 is consistent with the remedial purposes of the 1934 Act. A look at the legislative history of the Act, and section 10(b) in particular, makes clear that Congress intended to protect the investor specifically and the securities market in general from fraudulent and manipulative conduct.¹⁴⁶ Indeed, the Supreme Court has repeatedly characterized section 10(b) and rule 10b-5 as broad antifraud provisions, aimed at prohibiting the gamut of fraudulent practices.¹⁴⁷

Including certain gifts within the scope of rule 10b-5 is fully consistent with these prophylactic purposes. If a donative transfer of stock had a detrimental effect on the securities market or individual investors, such as the insider trading hypothetical from the introduction to this Note,¹⁴⁸ or if it were part of a fraudulent scheme, such as the fraudulently induced donation in the second hypothetical,¹⁴⁹ that donative transfer would be at the heart of the conduct Congress meant to prohibit.¹⁵⁰ Thus, imposing rule 10b-5 liability in such cases is entirely consonant with the Congressional purpose behind the 1934 Act.

D. *Scienter*

In *Ernst & Ernst v. Hochfelder*, the Supreme Court established a scienter requirement, holding that the plaintiff in a rule 10b-5 action must show that the defendant possessed the requisite mental state.¹⁵¹ Because some donors or donees might have acted with the requisite intent, the Court's scienter requirement does not necessarily place all gifts of stock outside the scope of the 1934 Act. The Supreme Court has defined scienter in this context as "a mental state embracing intent to deceive, manipulate, or defraud."¹⁵² The Court's definition is thus grounded in the language of section 10(b), specifically the terms "manipulative or deceptive" used with the terms "device or contrivance."¹⁵³ Certainly the typical bona fide gift — for example, a grandparent's gift of shares to a child — would lack the essential ele-

146. See *supra* notes 33-40 and accompanying text; *supra* notes 117-19 and accompanying text.

147. See, e.g., *Chiarella v. United States*, 445 U.S. 222, 226 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202-06 (1976); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

148. See *supra* text accompanying notes 1-4. Many commentators dispute the assumption that insider trading is an undesirable phenomenon. See, e.g., H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983). Because federal securities statutes currently prohibit insider trading, see *supra* note 1, this Note accepts the proposition that insider trading is undesirable.

149. See *supra* text accompanying note 5.

150. See *supra* section III.C; Brown, *supra* note 10, at 764 n.83.

151. 425 U.S. 185, 185 (1976). This case and the scienter requirement are discussed more fully *supra* in section III.D.

152. 425 U.S. at 194 n.12.

153. 425 U.S. at 197-98; see 15 U.S.C. § 78j(b) (1988).

ment of scienter. Such a bona fide gift would be made with a genuine donative intent — not the intent to defraud, deceive, or manipulate.

In some situations, however, an individual can make a donative transfer with the intent to defraud or deceive, or in an attempt to evade the proscriptions of the securities laws. The two hypotheticals described above provide good examples of donative transfers involving the required scienter. The first hypothetical, in which a corporate insider donates shares to a charity after obtaining nonpublic insider information, would clearly evince the donor's knowing and intentional attempt to circumvent insider trading regulations.¹⁵⁴ The second hypothetical, involving the solicitation of gifts via misrepresentations, demonstrates the donee's knowing and intentional attempt to defraud the giver.¹⁵⁵

Thus, the Court's holding in *Hochfelder* does not preclude the inclusion of all gifts within rule 10b-5 — it excludes only those donative transfers which are made without the requisite scienter. Indeed, donative transfers which manifest the required mental state, that is, those gifts involving an intent to defraud or deceive, strike at the heart of the conduct prohibited by section 10(b) and rule 10b-5.

V. IMPLICATIONS OF THE SUGGESTED APPROACH

The previous Part examined donative transfers in light of the elements essential to a rule 10b-5 sale. That Part concluded that some donative transfers of stock could exhibit those four elements, and thus are appropriately considered rule 10b-5 sales. This Part explores the implications of that conclusion. First, this Part discusses the application of the actual purchaser-seller requirement articulated by the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*¹⁵⁶ to donative transfers. This Part demonstrates that this requirement is inapposite to a fully consummated donative transfer, because the actual purchaser-seller requirement excludes only individuals who have not actively participated in a securities transaction. Next, this Part examines two related policy considerations, the fear of a drastic increase in rule 10b-5 litigation and the fear of a chilling effect on potential gift-givers, and finds them equally inapposite. Thus, inclusion of donative transfers within the scope of rule 10b-5 is supported by relevant policy concerns.

A. *The Actual Purchaser-Seller Rule*

The Supreme Court stemmed the growth of rule 10b-5 litigation

154. See *supra* notes 1-4 and accompanying text.

155. See *supra* text accompanying note 5.

156. 421 U.S. 723 (1976).

when it decided *Blue Chip Stamps v. Manor Drug Stores* in 1975.¹⁵⁷ *Blue Chip Stamps* irrevocably changed the future of rule 10b-5 litigation by sharply restricting the class of potential plaintiffs under that rule to actual purchasers and sellers.¹⁵⁸ This section asserts that the Court's holding in *Blue Chip Stamps* does not affect the standing of a donor or donee who wishes to invoke section 10(b) of the 1934 Act, so long as that individual actively participated in the transaction at issue.¹⁵⁹

In *Blue Chip Stamps*, the defendant provided a trading stamp service to retailers. As part of an antitrust consent decree, the defendant was required to offer its securities to various retailers who had previously used the stamp service. The plaintiff, one of the retailers who did not purchase the securities when first offered, alleged that misrepresentations accompanying the offer made the investment prospects look overly pessimistic.¹⁶⁰ The plaintiff further alleged that the defendant had deliberately phrased the prospectus in this way in order to discourage the plaintiff (and other retailers) from purchasing the stock.¹⁶¹

The Supreme Court rejected the plaintiff's claim, affirming the "actual purchaser-seller" rule or "*Birnbaum* rule" which states that only *actual* purchasers or sellers of a security have standing to bring an action under rule 10b-5.¹⁶² In *Blue Chip Stamps*, the Court reasoned that because the plaintiff had refrained from purchasing the se-

157. 421 U.S. at 723; see L. SODERQUIST, *SECURITIES REGULATION* 438-39 (2d ed. 1988); Jacobs, *Standing to Sue Under 10b-5 After Blue Chip Stamps*, 3 SEC. REG. L.J. 387, 388 (1976).

158. See 421 U.S. at 723.

159. A related issue that has arisen in the context of standing concerns the assignability of claims under the 1934 Act. In *Rose v. Arkansas Valley Envtl. & Util. Auth.*, 562 F. Supp. 1180 (W.D. Mo. 1983), plaintiffs alleged a variety of state and federal fraud claims, including a rule 10b-5 claim, against the issuer of worthless revenue bonds. The court dismissed the claims presented by three particular plaintiffs who had inherited their bonds, reasoning that investors who were "clearly neither 'sellers' nor 'purchasers' of [the] bonds" lacked standing to sue. 562 F. Supp. at 1188.

At first glance, *Rose* seems to rule out the possibility of a gift falling within the ambit of rule 10b-5 by denying standing to a recipient of a gift of stock. Nevertheless, *Rose* is consistent with the proposition that certain donative transfers fall within the 1934 Act. In *Rose*, the alleged misstatements and omissions occurred when the defendant initially transferred the bonds to the donor (but the donor was not the plaintiff in the case). There was no fraud alleged in conjunction with the transfer of the bonds from the donor to the plaintiff-donee. Put simply, the defendant did not fraudulently induce the plaintiff to purchase the bonds, but allegedly induced a third party, the donor, in an earlier and separate transaction. Thus, the court's primary concern was not so much with the type of transfer that had occurred (e.g., the gift-sale distinction), as with the directness of the plaintiff's relation to the fraudulent conduct. 562 F. Supp. at 1188.

160. See 421 U.S. at 726.

161. See 421 U.S. at 726-27.

162. See 421 U.S. at 749, 755; see also *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952). In *Birnbaum*, the plaintiffs were a group of shareholders who brought a class action against the corporation in which they owned stock. They alleged that various misrepresentations regarding a transfer of shares between two of the defendants defrauded the plaintiff-shareholders. 193 F.2d at 462. The Second Circuit affirmed dismissal of the complaint, holding that rule 10b-5 did not prohibit all instances of corporate misconduct. Because the plaintiffs had

curities, and thus had not actually bought or sold the securities, the plaintiff was not a purchaser within the meaning of the 1934 Act.¹⁶³

The Supreme Court's stated reason for adopting the actual purchaser-seller rule was the fear of "vexatious litigation which could result from a widely expanded class of plaintiffs."¹⁶⁴ The Court's concern was twofold: first, granting standing to potential plaintiffs who were only remotely related to any transaction would increase the likelihood of strike suits and frivolous claims; and second, the lack of a close nexus between the plaintiff and any transaction would markedly complicate questions of proof and causality.¹⁶⁵

The actual purchaser-seller rule, however, would not exclude every donative transfer of stock from the scope of rule 10b-5. The *Birnbaum* rule does not impose any structural requirements upon a rule 10b-5 transaction, but requires that the plaintiff have actively participated in that transaction. The doctrine screens out "might-have-been" transactions — transactions that did not actually occur, but which, absent the defendant's alleged fraud, might have taken place.¹⁶⁶ A typical donative transfer is not a "might-have-been" transaction; rather, it is a fully consummated transfer of stock. As long as the plaintiff has actively participated in the transaction, the actual purchaser-seller rule will not exclude that transaction from the scope of rule 10b-5.

B. *The Dangers of "Vexatious Litigation"*

Construing certain gifts as 1934 Act sales will not run afoul of the concern with spawning needless litigation which the Supreme Court articulated in *Blue Chip Stamps*. The Court, in adopting the actual purchaser-seller rule, believed that the rule would limit the number of prospective plaintiffs, thereby preventing strike suits and suits where proof of the relevant facts was likely to be difficult.¹⁶⁷ However, the danger of "vexatious litigation" concerning donative transfers would be minimal.¹⁶⁸ First, including gifts within the definition of "sale" would not expand the class of potential plaintiffs beyond those who

not personally participated in the allegedly fraudulent transactions, they had no standing under rule 10b-5, which protects only the defrauded purchaser or seller. 193 F.2d at 463-64.

163. See 421 U.S. at 754. In so holding, the Court noted that the consent decree did not give the plaintiff any contractual right to purchase the securities; had there been some contractual arrangement, the *Birnbaum* rule would not apply. See 421 U.S. at 749-50.

164. 421 U.S. at 740.

165. See 421 U.S. at 740-43.

166. For example, in the *Birnbaum* case, the plaintiffs alleged that the defendants rejected a merger which would have been extremely profitable for the plaintiffs. See 193 F.2d at 462. Although a breach of fiduciary duty was involved, plaintiffs did not directly participate in any transfer of stock. 193 F.2d at 463. Similarly, in *Blue Chip Stamps*, the plaintiffs did not actually purchase securities from the defendants, but sued because misrepresentations allegedly caused them to forgo purchasing securities. 421 U.S. at 727.

167. 421 U.S. at 740-44.

168. Brown, *supra* note 10, at 764 n.83.

actually transact in the security (although admittedly it could increase the overall number of rule 10b-5 plaintiffs). Plaintiffs, defrauded donors or donees of stock, will have actively participated in the transaction at issue. As mentioned in the preceding section,¹⁶⁹ the *Blue Chip Stamps* decision would exclude only those potential plaintiffs who *might have given or received* shares if not for the alleged fraud. Those individuals are the "might-have-been" transactors barred by the actual purchaser-seller rule.

Second, the class of potential plaintiffs under rule 10b-5 would also be limited in a practical sense. Only the donor, the donee, or the SEC would have standing to sue under rule 10b-5.¹⁷⁰ Moreover, practical constraints would naturally tend to limit the number of lawsuits involving donative transfers. It is likely that the number of donee-plaintiffs would remain small, because the typical donee presumably would not have suffered any real losses in accepting a gratuitous transfer of stock.¹⁷¹ This lack of incentive on the part of most donees would decrease the likelihood of "strike suits," thus effectively limiting standing to those who are genuine victims of fraud.

Since the actual purchaser-seller rule does not logically extend to the typical donative transfer, and since including gifts within the definition of "sale" would not unduly expand the potential class of plaintiffs, the *Blue Chip Stamps* holding does not preclude a gift of stock from being termed a sale.

C. The Chilling Effect

Interpreting certain donative transfers as rule 10b-5 sales will not create any appreciable "chilling" effect on potential gift-givers. One might argue that subjecting gifts to the strictures of rule 10b-5 would discourage parties from entering into donative transfers. Assuming that society as a whole benefits from the process of gift-giving, particularly in the context of charitable contributions, any such chilling effect would create significant policy considerations that might militate against application of rule 10b-5 to donative transfers.

However, at least two reasons explain why such a chilling effect will not materialize. First, as a practical matter, the parties to a transaction would not have any incentive to bring suit under the 1934 Act absent some sort of serious fraud or misrepresentation. For example, consider a common gift-giving situation in which a relative donates

169. See *supra* section V.A.

170. See 15 U.S.C. § 78u(d) (1988) (authorizing the SEC to bring injunction proceedings in federal court); 15 U.S.C. § 78u-1 (1988) (authorizing the SEC to seek civil penalties in federal court); Brown, *supra* note 10, at 764 n.83.

171. See Brown, *supra* note 10, at 764 n.83. One possible occasion where the donee might suffer a loss would be if the donee in some way relied on the stated value of the gift to her detriment.

shares of stock to a child. Unless some sort of fraudulent conduct is involved, the donee will generally be better off after receiving the gift, and would have no incentive to bring suit. In addition, the close ties that often exist between a donor and donee may make it even less likely that either would wish to sue in connection with a gift.

Second, where an individual makes a bona fide gift — a gift with no intent to defraud or deceive — a plaintiff would be unable to plead or prove scienter. Since the Supreme Court has held that scienter is an essential element of a rule 10b-5 claim,¹⁷² parties to a bona fide donative transfer need not fear liability under rule 10b-5. Only those donors who consciously intend to defraud or deceive would manifest the requisite scienter and be exposed to rule 10b-5 liability.¹⁷³ Thus, an individual making a bona fide gift, whatever the circumstances, would not be exposed to liability, and should not be discouraged from giving.

In sum, none of the above policy considerations — the policies giving rise to the actual purchaser-seller rule, the fear of excessive litigation, or a potential chilling effect on gift-givers — is a likely outcome should gifts be included within the ambit of rule 10b-5. To the contrary, inclusion of those donative transfers which demonstrate the four characteristics of a rule 10b-5 sale would further the broad antifraud purposes that underlie congressional adoption of the 1934 Act.

CONCLUSION

Section 10(b) of the Securities and Exchange Act of 1934 and rule 10b-5 promulgated thereunder are sweeping provisions aimed at prohibiting a wide range of fraudulent and manipulative conduct. Section 10(b) and rule 10b-5 are limited by their language to fraudulent and manipulative conduct that occurs "in connection with the purchase or sale of any security."¹⁷⁴ However, the contours of that phrase are ill-defined; courts have found a multitude of transactions to be rule 10b-5 sales, without articulating a consistent framework for their conclusions.

Consequently, the status of donative transfers under rule 10b-5 is unclear. The statutory language and legislative history of section 10(b) and rule 10b-5 do not address donative transfers directly, although inclusion of fraudulent or deceptive gifts is consistent with the language and purposes of the statute and the rule. Moreover, courts have only analyzed gifts of stock under section 16(b) of the 1934 Act, a substantially different provision of that Act. Therefore the status of gifts of stock under section 10(b) and rule 10b-5 remains unresolved.

172. See *supra* section III.D.

173. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

174. 15 U.S.C. § 78j(b) (1988); 17 C.F.R. § 240.10b-5 (1988).

Judicial analysis of transactions with regard to rule 10b-5 yields a rough framework for evaluating borderline transactions. Three characteristics of a rule 10b-5 sale have emerged from the case law: (1) a transfer of ownership or control of the security; (2) some exchange of value or consideration; and (3) consistency with the remedial purposes of the 1934 Act. In addition, the transaction must demonstrate the requisite mental state, scienter. These elements provide a method for evaluating transactions to determine if they are within the scope of rule 10b-5.

Application of these characteristics demonstrates that certain donative transfers should be treated as rule 10b-5 sales. Donative transfers always involve an ultimate disposition of a security, satisfying the change in ownership requirement. In addition, certain types of donative transfers may involve some exchange of value or consideration between the parties. Where a donative transfer defrauds investors or adversely affects the integrity of the securities market, application of rule 10b-5 is especially warranted because application would further the remedial purposes of the 1934 Act. Requiring a showing of scienter, moreover, ensures that only donative transfers involving deception or fraud will be subject to rule 10b-5 liability. Finally, policy considerations support the inclusion of donative transfers within the ambit of rule 10b-5. By adopting the suggested framework, courts could clarify the definition of a rule 10b-5 sale, while reaching out to a type of fraudulent conduct that masquerades in the guise of a gift.

— Carol J. Sulcoski